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# Minutes

## Board of Natural Resources Meeting

February 5, 2008  
Natural Resources Building, Olympia, Washington

### BOARD MEMBERS PRESENT

The Honorable Doug Sutherland, Commissioner of Public Lands

Bruce Bare, Dean, University of Washington, College of Forest Resources

Daniel J. Bernardo, Dean, Washington State University, College of Agricultural, Human, and Natural Resource Sciences

The Honorable Jon C. Kaino, Commissioner, Pacific County

Bob Nichols, for the Honorable Christine Gregoire, Washington State Governor

The Honorable Terry Bergeson, Superintendent of Public Instruction

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### CALL TO ORDER

Chair Sutherland called the meeting to order at 9:07 a.m. on, February 5, 2008 in Room 172 of the Natural Resources Building. He explained that due to the amount of snow and the condition of the roads, the Board tour of the storm damaged areas is postponed until further notice.

### APPROVAL OF MINUTES

MOTION: Terry Bergeson moved to approve the January 8, 2008 Board of Natural Resources Meeting Minutes.

SECOND: Bruce Bare seconded.

ACTION: Motion passed unanimously.

### PUBLIC COMMENTS FOR AGENDA ACTION ITEMS

None

### TIMBER SALES (Action Item)

#### Proposed Timber Sales for March 2008 (Handout 1)

Jon Tweedale, Assistant Division Manager, Product Sales & leasing Division greeted the Board. He explained that curtailments have changed the dynamics of the market. Most mills are running at decreased capacity, meeting their end user demand which is pushing back the supply. Brokers are back in the game and are being discriminating in what they are purchasing for their mills. There is no discrimination in the quality anymore which is an interesting dynamic; mills are not discriminating against small diameter hemlock and low grade timber.

Terry Bergeson asked Mr. Tweedale to explain.

Mr. Tweedale replied that the better quality Douglas fir sales that would sell in almost any market did not sell this month. The mills are simply buying for their needs right now; they are watching and waiting to see what the bottom of the market is. What DNR is selling, is selling for good prices. He feels that the supply and demand are out of balance. They are noticing regional differences in supply and demand; for example, Northwest and South Puget Sound regions sold all of their sales this month at good prices in a competitive marketplace. He thinks it's because the number of mills buying in the area and the supply matches what they need. One major mill is not following that pattern and is running three shifts which puts pressure on the rest of the mills in those regions. Pacific Cascade Region has a more diverse supply available than just DNR's supply, which gives more options than the north end. The mills in the south end don't need to run; they are pretty solvent and paid off, so they can run to meet their buyer's needs for lumber. If they can't get rid of it they won't buy stumpage. Even in the Pacific Cascade Region the sales that sold brought good prices.

Bruce Bare asked Mr. Tweedale if he could recall when the last time was that DNR only sold about half its sales.

Mr. Tweedale stated that back in 2002 a similar situation occurred. When the market moves too quickly downward, the Department is not able to adjust the price quickly enough. A few months ago DNR had 60% of sales receive no-bids, the prices were adjusted and for the next 2 -3 months all sales sold. Tweedale said the market dropped again and DNR is behind the curve. Where timber is selling DNR got 30% to 35% up-bids.

Bruce Bare stated that the three sales that had multiple bidders had significant bid premiums.

Mr. Tweedale agreed, stating that DNR is receiving good fair market value prices.

January 2008 Sales Results:

19 sales offered & 10 sold; 84.3 mmbf offered & 45.3 mmbf sold; \$19.8 million minimum bid & \$12.8 million sold; \$235/mbf offered & \$282/mbf sold; average number of bidders = 2.2

Chair Sutherland asked if DNR was planning to re-market the no-bid sales

Mr. Tweedale replied that it will. He brought three March sales to the Board's attention due to the fact that they have some blowdown in them.

Bruce Bare asked if DNR has already adjusted for that.

Mr. Tweedale stated that it has.

Jon Kaino pointed out that the Wheaties sale has been a no-bid twice.

Mr. Tweedale replied that this is true; this is a larger piece size Douglas fir sale.

Dan Bernardo asked about the regionality of the market and if DNR can try to change direction as it moves forward.

Mr. Tweedale stated that DNR has little flexibility to move volume from region to region, it has to do the best it can to balance the risk tolerance. He is confident that the Department will see more activity in the spring and summer.

Chair Sutherland asked if the 100 mmbf of blowdown on trust lands and the additional 500 to 600 mmbf of blowdown on private lands, that are mostly located in Southwest Washington where the market is the weakest, will have an impact over the next 6 to 8 months.

Mr. Tweedale replied that it could but because the Sierra Pacific Mill in Grays Harbor and the Hungry Mill in Centralia are running at full operation, they have a large commitment for wood from Weyerhaeuser. When the mills get back to double shifts a big change will take place.

Jon Kaino asked how long it will take to get to the blowdown ready to go out.

Mr. Tweedale replied that DNR anticipates the first sales coming forth in May. It's taking advantage of existing sales, where there is volume adjacent to a sale DNR is expanding the sales within the rules where it can. DNR is taking action on blowdown and is moving some of the volume. The Department anticipates contract harvesting a 600 to 700 acre block in May. It is pre-qualifying a large list of harvesters. Contract harvesting is a good tool in this kind of market to merchandise and maximize value.

Mr. Kaino asked if there will be any consideration to postpone standing timber sales if the market continues to decline. He stated that he is afraid there will not be enough people to complete the logging.

Bruce Bare stated that is a tough call because of the competing financial and ecological objectives within the Department. He said that with each year that the timber harvest is slowed down it creates a delay in reaching those future stand structure conditions that DNR is trying to manage for.

Mr. Tweedale explained that all DNR can do is to sell into the strengths of the market. DNR is accomplishing multiple goals, increasing cash flow to the trusts and is ahead on revenue

Chair Sutherland stated that he was not sure the Department is ahead on revenue.

Mr. Tweedale apologized stating that he didn't mean this year, but rather on the sustainable harvest plan.

Mr. Bare stated that part of the sustainable harvest plan was to engage in more thinning to accelerate the development of complex stand structures and now the Department is finding this coinciding with a terrible market making it more difficult to market those smaller trees.



Mr. Tweedale replied that DNR's average price will be down.

Mr. Kaino asked if Mr. Tweedale was saying that the strength of our market is irrelevant with respect to our sales program.

Mr. Tweedale replied that DNR sells into the strength of the yearly cycle, which has strengths and weaknesses on a quarterly basis, then it sells into the relative strength within each year.

Terry Bergeson understood Mr. Tweedale to be saying that in spite of all the forces that are at work it doesn't change that underlying cycle.

Mr. Tweedale agreed.

Chair Sutherland noted that DNR has not set aside its sales program to concentrate on the salvage sales. He has asked Bruce Mackey, Lands Steward and his staff to create a task force bringing staff from other regions and programs to focus on the salvage efforts in a timely manner. He'd like those sales to be offered along with the normal sales. There may be times when one of the scheduled sales may be delayed through volume or market push back so DNR can be prepared to have product in the market. The big concern over the next nine to twelve months is that the Department has as much of the blowdown material ready for the marketplace as possible. The Board should expect existing sales to be expanded in order to take advantage of equipment and staff already in place.

Ms. Bergeson asked if the Department is double teaming the efforts.

Chair Sutherland replied that this is exactly what DNR is doing, not only in the region but in supportive areas here. These issues need to be taken care of because DNR is not sure what the fire season is going to be like. Additional staff is being brought in to take care of DNR's proprietary efforts, as well as the private sector and its forest practice application process. The goal is to try to process the applications within a 15 day window which takes coordination with the Department of Fish & Wildlife and others.

Dan Bernardo addressed Mr. Tweedale stating that he agreed with the comment about selling into the fundamentals of the market cycle. He has done work that supports the notion that trying to outguess the market is not a sound long-term strategy like sticking with a fundamental strategy, which may change because this product is perishable.

Mr. Tweedale agreed that it is an efficient market and DNR needs to understand the trends and sell into it.

Ms. Bergeson stated that we need to be careful not to lose our foundation of principles surrounding our long term intensive silviculture strategy to build habitat.

Mr. Tweedale moved on to the March sales. The forest practice application appeal period for the Solid Gold and Dr. Pepper sales won't be completed until after today, but will be completed prior to auction.

Proposed March 2008 Board Sales:

19 sales at 84.3 mmbf; \$17.9 million minimum bid; average \$197/mbf.

MOTION: Terry Bergeson moved to approve the March 2008 timber sales.

SECOND: Jon Kaino seconded.

ACTION: Motion passed unanimously.

Mr. Tweedale pointed out that DNR will be working aggressively on the Rue Creek drainage and Browning Block sales to make sure the Department is taking care of its obligations.

## **LAND TRANSACTIONS**

NONE

## **CHAIR REPORTS**

Terry Bergeson noted that she has been working on bills that pertain to sustainability. She stated that she likes the idea of being able to broker projects that have environmental impacts for kids who have senior projects as part of the graduation requirement. A bill may pass that supports some ability through PEI (Pacific Education Institute) to help build learning towards sustainability.

Chair Sutherland stated that it is exciting to see that happening.

### Management Fee Update (Handout 2)

Bob Van Schoorl, Director of Budget & Economics Division approached the Board to provide an update on the revenue forecast. He provided a spreadsheet that displayed what has happened over the last eight months relative to the forecast. He discussed the trends in timber sales which required some adjustments to the operating sales volume. Prices have dropped 32% from a \$396/mbf last January to \$270/mbf this January which is raising concerns.

Mr. Bare asked if the spreadsheet reflects forecasted prices.

Mr. Van Schoorl replied that it does and that the \$396 and \$270 prices are real.

Chair Sutherland asked if the \$270/mbf includes the region sales.

Mr. Van Schoorl stated that it does and that their prices take into account all the sales. The forecasting price is down about 11%.

Mr. Bare asked if Mr. Van Schoorl is assuming that the rest of the sales for the biennium will average \$300/mbf.

Mr. Van Schoorl stated that was correct. Some contract lengths have been shortened, but buyers are sitting on their timber as long as they can, waiting for the market to turn around; there has been a drop in removals from 1.3 to 1.1 and the price is trended down along with that over the biennial forecast. Timber harvest revenues are down about \$85 million dollars. The Department is netting out at an \$82 million dollar drop in revenue for the biennial forecast even though some oil and gas lease revenues are up. The RMCA (Resource Management Cost Account) is down about \$20 million, and another \$6 million in the FDA (Forest Development Account). Mr. Van Schoorl pointed out the first chart showing that DNR began the current biennium with just over \$14 million in the bank, with expected revenue of \$67.6 million as compared to \$88 million in the RMCA; expenditures have held constant, which will change. The Department has dropped from an ending fund balance projection of \$18.7 million to negative \$0.1 million fund balance. The minimum operating fund balance is down \$9.8 million. The FDA fund balance is below the 6 month minimum fund balance at \$5.8 million which will trigger the increase of the 22% management fee back to the 25% that is indicated by the 1997 resolution.

Chair Sutherland stated that would be by resolution in the March meeting.

Mr. Bare asked when the FDA account dropped below the minimum fund balance.

Mr. Van Schoorl explained that it is not tracked on a monthly cash flow basis; they look at the biennial fund balance. He estimated that they would trigger it in July.

Jon Kaino asked what the resolution is going to say.

Mr. Van Schoorl replied that the next chart will answer his question.

Mr. Bare asked if the ending balance could be shown at the end of the fiscal year on June 30, 2008.

Mr. Van Schoorl replied that the Budget & Economics Division could do that, as it runs its fund balance reports on a biennial basis and does have them on fiscal years. Mr. Van Schoorl noted that the second chart showed the impact of the management fee from a 28% to 30% increase and would generate \$3.5 million of additional revenue, but would still leave a negative fund balance and would require internal work to get the expenditures within the fund balance. If they were to increase the FDA on April 1<sup>st</sup> it would trigger the 25 % if the account drops below the minimum fund balance.

Mr. Kaino asked what if any assumptions are made on the market as it declines during the fee evaluation.



Mr. Van Schoorl replied that he and his staff work with Jon Tweedale and Jed Herman as well as obtaining information from RISI, Clear Vision, and other national and international forecasting services to determine what the market may be.

Ms. Bergeson asked if both are looking at the bottom of the market not coming until next year.

Mr. Van Schoorl replied this was correct. There was some discussion around the terms conservative and localized, he explained how they differ in how they look at the market.

Chair Sutherland stated that he thinks they are driven by the inventory in the housing market.

Mr. Bare asked if Mr. Van Schoorl had extended the numbers out on the RMCA ending fund balance based on the harvesting of 1.134 mmbf and selling at 1.322 mmbf.

Mr. Van Schoorl replied that the Budget & Economics Division makes some assumptions about whether the logs coming out are trust or forest board logs. It also uses sales information from the programs to project that out.

Mr. Bare stated that it would be helpful to see a scenario wherein other prices were assumed. He asked what the distribution of prices around the expected price is.

Mr. Van Schoorl stated that in the past they have done the optimistic vs. pessimistic approach, and can run the numbers changing the price assumptions. He stated that he and Bruce Mackey, Lands Steward, planned to meet to talk about some of the sensitivities around the different factors that are assumptions in the forecast, which may drive operational decisions. It doesn't make any difference if DNR comes out at 25% or 30% for the management fees, it would take at least a \$350 mbf price to turn the numbers around.

Mr. Bare stated that would be a good piece of information.

Mr. Van Schoorl stated that none of the blowdown is included in this calculation. If, in fact, DNR gets 100 mmbf out from harvesting blowdown, it doesn't have any idea what the price will be, but the 100 mmbf isn't going to impact the management fee.

Mr. Bare stated that he would like to see what price it would take to meet the minimum fund balance.

Mr. Van Schoorl replied that he will provide that.

Mr. Bare replied that there are probably some counties and trust beneficiaries that would like to see that information. He asked if there is a statute that provides guidance related to the level of fund balance that we are required to maintain.

Mr. Van Schoorl replied that there is an agency/OFM (Office of Financial Management) standard of three months; the six months of FDA balance was the result of a 1997 board

resolution that directed the rate to be lowered to 22% as long as the FDA maintained an operating reserve greater than 6 months.

Mr. Kaino stated that in 1997 the fund balance was significant. He recalled that the counties came and asked why DNR was taking 25%, so the Board lowered the fee to 22% with the caveat that it would automatically kick back up when the fund balance reached an operating reserve of three months or less.

Mr. Bare asked if this is the same with the RMCA.

Mr. Van Schoorl replied that it is the same, three months.

Mr. Kaino stated that the only 6-month caveat on the FDA is that if it gets below that it triggers an increase in the fee. He stated that if it costs DNR 33% to set up the blowdown sales, it is not a cushion, it is a draw down.

Ms. Bergeson stated that it's good that they didn't include them.

Mr. Van Schoorl replied that DNR loses money on the RMCA or FDA side, but on the other hand it helps meet the sustainable harvest volume. The other thing to look at is that the numbers that were calculated for the decadal harvest were 300 mbf, so we have done fairly well against the sustainable harvest. DNR is getting the ramp up and the prices it's getting are good when compared to the numbers it looked at when it did the sustainable harvest calculation several years ago.

Ms. Bergeson requested a background paper explaining what we are doing and why we are doing it as we pass the resolution next month. She'd like to review the numbers and the rationale behind why the triggers were put in place.

Mr. Kaino stated that he had made a presentation to the timber counties last year alerting them to the FDA trigger and they voted to support the increase; they are expecting it.

Mr. Van Schoorl explained that the statute allows for a 25% maximum management fee rate on the RMCA. The budget proviso authorizes the Board to set that rate up to 30% and we did that based on the first couple of months through September of this biennium. The Board voted for the 28% the first of October or November. It is a Board resolution that sets that and it will revert to 25% at the end of this biennium unless other action occurs by the legislature. The decision comes back to the Board and that is why it is reported back on a quarterly basis.

Ms. Bergeson stated that she wanted it laid out on paper.

Mr. Bare asked how the minimum fund balance is set.



Mr. Van Schoorl explained that it is calculated on the operating part of the budget not on the capital, or the new item called transfers, which is really operating money. The factor is 12.5% of \$77.6 million which is three months, or one eighth of the biennium.

Mr. Bernardo stated that in this environment it doesn't make much sense to have operating expenditures that same as they were.

Mr. Van Schoorl replied that discussions have taken place throughout DNR about how to cut operating expenses, keep revenue coming in and project how to keep the RMCA balanced as a whole making sure there is adequate cash.

Mr. Bare asked Mr. Van Schoorl to run a scenario keeping the management fee constant and to draw the operating expenditures down to see how much expenditures have to be cut to keep the RMCA fee at 28%.

Mr. Van Schoorl estimated that the account is down to \$6.5 million.

Ms. Bergeson stated that DNR's customers have to trust the fact that the Department is balancing what it can do to tighten belts within the organization as well as increasing that portion of the fee. It is important to have that trust.

Mr. Kaino agreed that trust is the key. He agreed with Mr. Bare's scenario of running the operating expenditures down as long as lowering operating expenditures doesn't impact the revenue which defeats the purpose.

Mr. Van Schoorl stated that DNR will maintain the cut and volume, but that when you start cutting on others you rob from the future.

Mr. Bare recalled that in this biennium DNR received additional money for staff positions to implement the sustainable harvest.

Chair Sutherland noted that the Department got authorization to spend, not additional money.

Mr. Bare stated that if the legislature allocates additional funds to add DNR staff to increase the sustainable harvest and, because of timber price reductions, it is forced to reduce staff, then it should make staff reductions in program areas unrelated to the sustainable harvest in order to minimize the impact on the latter, otherwise we may be at odds with the legislature.

Ms. Bergeson stated that this is a complicated organization but she has hope because of the sense of team within the agency to weather the crisis and sustain the basic principles.

Mr. Kaino stated that the reality is that regardless of the quality of DNR's policies, its planning and its staff, if it drops another 32% twelve months from now, there will be problems.

Chair Sutherland thanked Mr. Van Schoorl for his presentation.

## **PUBLIC COMMENTS FOR GENERAL ITEMS OF INTEREST**

Bob Dick of the American Forest Resource Council approached the Board. He commended Mr. Tweedale on his overview of the marketplace, but addressed his disagreement with Mr. Tweedale's prediction of stumpage trends throughout the year.


Mr. Dick stated that Mr. Tweedale argues that stumpage values can be predicted throughout the year with a premium of stumpage in the spring months. Mr. Dick has looked at the data and does not see the trend. He feels that markets are complex and are affected by macro and micro economics, macro and micro politics, competition within the industry, and catastrophic weather. He reminded the Board that a year and a half ago he informed them that the market had died and to be ready for no-bid sales. There is no doubt that lumber prices fluctuate on an annual basis; the demand for lumber in the springtime is always more than the fall, and prices tend to go up; stumpage prices do not follow that trend. Mills operate year round; they don't operate putting out wood in the spring or reducing their production in the fall for market production. Mill based prices are based on risk of purchasing stumpage. If you reduce the amount of risk you will increase the comfort with which the mills buy wood, increasing the willingness to compete for the wood, translating into an increase in price to the Department. A steady predictable supply minimizes risk; he is not arguing that timber sales from DNR should never vary, however he does argue for a stable, steady, predictable supply. Dumping sales in early winter months does not maximize the value; that puts them in the position of going out into the woods when the snow is the deepest, as well as trying to find people to cruise timber in a collapsed time of year when there aren't enough people to do that forcing mills to make a decision as to which timber sales they will look at. In more predictable times they would look at all the sales and feel they can bid more strongly on sales that they don't look at. His experience with bidding on sales that haven't been looked at is that you put in a minimum bid and not much more than that. His message is to not dump a whole lot of timber in the last few months of the fiscal year; he feels that you do not maximize the amount of income from the timber sales program by doing that.

Chair Sutherland thanked Mr. Dick for his comments and informed the Board members that he will reschedule the storm damage tour in April.

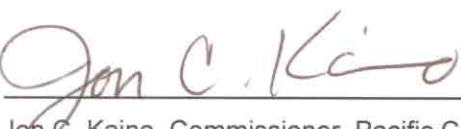
Meeting adjourned at 10:30 a.m.

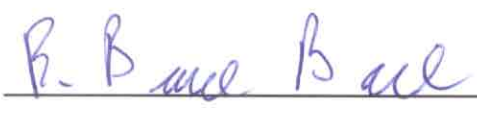
Approved this 4<sup>TH</sup> day of MARCH, 2008

  
Doug Sutherland, Commissioner of Public Lands

  
Bob Nichols for Governor Christine Gregoire

  
Terry Bergeson, Superintendent of Public Instruction

  
Jon C. Kaino, Commissioner, Pacific County

  
Bruce Bare, Dean, University of Washington

  
Daniel J. Bernardo, Dean, Washington State University

Attest:

  
Bonita Hill, Board Coordinator